



GLOBAL MARKET'S REPORT “Outperformance of ESG funds”

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INTRODUCTION

The following report aims to provide insights into the primary distinctions between ESG and non-ESG funds, including main characteristics, investment strategies, and regulatory variances. Drawing inspiration from ESMA's market research, the focus shifts towards the increased attractiveness of ESG funds in terms of net flows during the turbulent COVID-19 period, marked by high volatility and market uncertainty. Furthermore, the analysis seeks to identify and assess the key drivers behind the outperformance of ESG funds compared to their peers during the analysed period, elucidating the different portfolio composition and cost dynamics proper of ESG funds. Lastly, it delves into how ESG investing holds the potential to yield positive impacts on returns for investors.

ESG FUNDS VS NON-ESG FUNDS: THE KEY FEATURES

The focus on ESG issues dates back to the 1970s. This subject has significantly influenced finance and investments, through external forces but also within the investment community itself. In 1971, the first sustainable mutual fund (PAXWX) by Pax World was established, marking the beginning of a series of subsequent developments, events and initiatives that have shaped the culture of ESG investing. Among the most notable ones are the launch of the Dow Jones Sustainability Indices (DJSI) in 1999; the issuance of the first green bond by the European Investment Bank (EIB) and the launch of the MSCI World ESG in 2007; the establishment of the Sustainability Accounting Standards Board (SASB) in 2011; the introduction of the S&P 500 ESG index in 2019; and last but not least, the famous quotation: *"climate risk will lead to a significant reallocation of capital"* by Blackrock CEO Larry Fink in his usual annual letter to CEOs in 2020.

The number of ESG funds has increased substantially, distinguishing themselves in particular from non-ESG funds by their investment choices and criteria, emphasizing sustainability and responsibility practices. Thus, ESG funds meticulously analyse the social, environmental, and governance impacts of their investments. In contrast, non-ESG funds do not necessarily prioritize social and/or environmental objectives or constraints, typically investing based on analysis and evaluation of pure financial returns and return on investment.

Other fundamental differences lie in risk analysis, where ESG funds incorporate environmental, social, and governance risks into their decision-making processes, whereas non-ESG funds primarily focus on more traditional risks such as volatility, price, exchange rate, interest rate, and liquidity. Additionally, the objective of return differs, as it is maximized net of social and environmental impact in ESG funds. Portfolio implications can be different, especially in terms of diversification, which may be more limited compared to a regular fund due to the exclusion of companies that do not adhere to ESG criteria.

Furthermore, another difference between the two types of funds concerns corporate governance. Particularly, if the fund's stake is significant enough to have influence on the board of directors, usually there is greater activity and involvement from ESG fund managers to influence and propose practices to enhance the company's ESG behaviour.

Finally, to avoid greenwashing practices, CFA Institute published the first voluntary Global ESG Disclosure Standards for Investment Products in June 2022. These guidelines provide investors, and by extension ESG fund managers, with important guidance on how investment products incorporate ESG issues into their objectives, investment process, and stewardship activities.

SFDR – EUROPEAN SUSTAINABLE FINANCE DISCLOSURE REGULATION

Introduced by the European Union in March 2021, the Sustainable Finance Disclosure Regulation (SFDR) is revolutionizing the financial industry through robust and comprehensive guidelines aimed at enhancing transparency and accountability. It mandates that funds offered and developed in Europe categorize themselves as either ESG (under Article 8 or 9) or non-ESG (Article 6). As concerns ESG funds, they are asked to outline their contribution to “Environmental & Social characteristics” (for Article 8 funds) or to focus their investment strategy around “sustainable investments” (for Article 9 funds). Currently, the regulation deliberately leaves the criteria for what qualifies as an Article 8 or 9 fund broad, while prioritizing the clarity and role of the ESG elements in the financial product. This approach grants asset managers considerable leeway in defining what constitutes an ESG fund.

SFDR – ARTICLE 6

Article 6 outlines the disclosure requirements for funds lacking a sustainability emphasis. This includes funds whose investment strategies are not focused on sustainability, potentially incorporating sectors often excluded from ESG funds, such as tobacco and thermal coal industries. Despite being permissible in the EU market, these funds must clearly identify themselves as non-ESG and transparently disclose their lack of consideration for ESG criteria. Article 6 encompasses a broad range of investment funds, including both UCITS (Undertakings for Collective Investment in Transferable Securities) and AIFs (Alternative Investment Funds). Article 6 requires asset managers to provide information on sustainability risks and how these are considered in the fund strategy.

Funds under Article 6, lacking a sustainability emphasis, could encounter difficulties as sustainable funds are becoming increasingly favoured. Research conducted by MSCI has shown that the inclusion of ESG criteria often results in improved long-term risk-adjusted returns. Consequently, funds not focused on sustainability might find it challenging to appeal to investors who value sustainability and could lag sustainable funds in terms of performance.

ARTICLE 8 AND ARTICLE 9

Article 8, often referred to as “light green”, encompasses financial products that promote environmental, social, or a combination of these features, on the condition that the invested companies adhere to sound governance practices. To qualify a financial product under Article 8, market participants need to apply various criteria, including the United Nations’ Sustainable Development Goals and the OECD Guidelines for Multinational Enterprises, alongside their due diligence processes. Compliance with Article 8 requires transparency in pre-contractual documents about:

- The approach to achieving environmental or social characteristics.
- Details on reference benchmarks if used, and their alignment with the environmental and social qualities.
- The methodology behind the calculation of any specified index.

In other words, Article 8 is applied to funds that endorse environmental and social aims without making ESG goals their primary focus, distinguishing them from Article 9 funds that have ESG objectives at their core.

Article 9, known as “dark green”, targets financial products which have sustainable investment as their primary objective. Article 9 funds are required to outline in their pre-contractual disclosures the methods by which they will achieve this objective and to ensure that their investments do not cause significant harm. The definition of “sustainable investment” under Article 9 can be categorized into three approaches:

- An environmental objective recognized by the EU Taxonomy.
- An environmental objective not covered by the Taxonomy, allowing asset managers to determine the environmental goal as they deem appropriate.
- A social objective, defined at the discretion of asset managers, particularly relevant as a social Taxonomy has not been finalized yet.

Most asset managers label funds with Article 9 as those that employ thematic or impact investment strategies- like climate transition, alignment with the Sustainable Development Goals (SDGs), EU Taxonomy alignment, or having specific ESG-related goals such as reducing carbon footprint or achieving higher ESG than a benchmark. The sophistication level among Article 9 funds varies, since asset managers may use different methodologies to assess a fund’s ESG performance or impact. Some rely on ready-made solutions, while others develop their own unique frameworks, however the SDGs and the EU Taxonomy are among the most straightforward methods to identify “sustainable investments”.

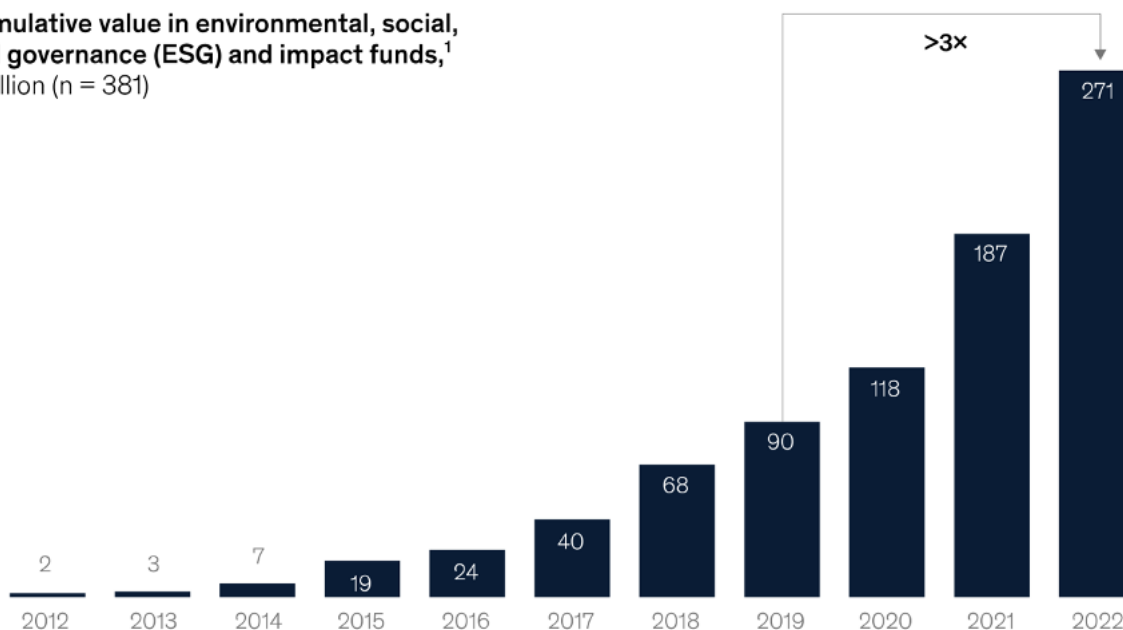
GROWING CAPITAL INFLOW INTO SUSTAINABLE FUNDS

From 2019 to 2022, the ESG fund landscape saw significant growth. Specifically, the cumulative assets under management (AUM) in sustainability, ESG, and impact funds tripled, growing from \$90 billion to more than \$270 billion. The surge in sustainable investment is significantly driven by increasing demand for renewable energy, underpinned by the broader adoption of renewables like solar and wind energy. This trend is accelerated by policy measures and incentives for clean energy, which have fostered an environment where renewable energy sources are more readily adopted and integrated into the mainstream energy mix. For example, corporate power purchase agreements for clean energy in the United States have seen an eightfold increase since 2015, demonstrating a substantial shift in demand towards renewable energy sources. This change not only reflects a growing commitment to sustainability but also highlights the economic viability and increasing competitiveness of renewable energy solutions in the market.

In the realm of sustainable investing, government policies and regulatory actions have been pivotal in shaping the landscape. Notably, initiatives like the European Union's Green Deal, Fit for 55, and RePowerEU have progressively amplified emission reduction targets, thereby accelerating the transition to green energy. These efforts were complemented by expansions in the Emissions Trading System to include sectors like maritime and aviation, marking a significant step in broadening the scope of climate action. Similarly, the Inflation Reduction Act in the United States earmarked \$370 billion towards fostering new energy solutions, showcasing a monumental commitment to sustainable development. China's introduction of an emissions trading system, now the world's largest, underscores the global momentum towards carbon pricing and emissions control. Such regulatory frameworks not only incentivize but also mandate a shift towards cleaner energy and sustainable practices, creating fertile ground for investments in green technologies.

Cumulative capital raised for funds related to environmental, social, and governance efforts tripled between 2019 and 2022 to about \$270 billion.

Cumulative value in environmental, social, and governance (ESG) and impact funds,¹ \$ billion (n = 381)



¹Cumulative final closed size in ESG, climate, Sustainable Finance Disclosure Regulation, and impact buyout or infra funds where fund size has been disclosed. Source: PitchBook; McKinsey analysis

McKinsey & Company

The alignment between capital markets and the global financial system in supporting the energy transition has been critical. Over 450 financial institutions, comprising the Glasgow Financial Alliance for Net Zero, have pledged an astounding \$130 trillion towards achieving net-zero emissions goals. This commitment reflects a substantial and robust financial backing for climate technologies and ESG investments. Such alignment showcases a significant shift in investment strategies, prioritizing sustainability and acknowledging the long-term financial viability of supporting a low-carbon economy. This movement towards sustainable finance signifies a broader understanding within the financial sector that investing in climate solutions and ESG funds is not only beneficial for the planet but also offers substantial economic opportunities. The concerted effort by these financial institutions to finance the energy transition marks a transformative moment in investment history, emphasizing the critical role of the financial sector in achieving global sustainability goals.

The cumulative impact of these governmental strategies extends beyond immediate environmental benefits, paving the way for a sustainable economic framework. By establishing clear regulations and providing financial incentives, governments worldwide are effectively lowering the barriers for entry into the green market, thereby attracting significant investment flows into ESG funds. This regulatory support is crucial for the development and deployment of renewable energy sources, energy-efficient technologies, and other climate solutions that are essential for achieving net-zero targets.

ESG INVESTMENT INSTRUMENTS

At the core of sustainable investing is the premise that companies adhering to higher standards in environmental performance, social responsibility, and governance practices are better positioned for long-term success. This belief is supported by a growing body of research indicating that ESG factors, when

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integrated into investment analysis and portfolio construction, may offer competitive returns and lower risk profiles compared to traditional investments.

Here are some of the best-performing (considering from 2019) ESG mutual funds considering the total return of S&P500 Index is 12.08%.

Ticker	Fund name	5-year annualized return
VMGAX	Vanguard Mega Cap Growth Index Instl	19.59%
BDAUX	Baron Durable Advantage R6	19.35%
BDAIX	Baron Durable Advantage Institutional	19.34%
NGDLX	Neuberger Berman Large Cap Growth Inst	18.9%
AMIGX	Amana Growth Institutional	17.9%
HACAX	Harbor Capital Appreciation Instl	17.5%
TWCGX	American Century Growth Inv	17.48%

ESG (Environmental, Social, and Governance) funds and ETFs (Exchange-Traded Funds) have emerged as central financial instruments for investors intending to align their portfolios with their ethical, environmental, and governance values. This burgeoning interest is underpinned by the growing awareness of climate change, social justice issues, and the need for transparent corporate governance. The landscape of ESG funds and ETFs is diverse, ranging from broad-market funds that apply a light ESG filter to highly specialized products focusing on specific themes such as clean energy, water conservation, or gender diversity. For instance, certain ETFs may track indices designed to exclude companies involved in controversial activities like fossil fuel production or tobacco, while others invest in companies leading in renewable energy technology or exhibiting strong labor practices and board diversity. Technically, these financial instruments operate similarly to their traditional counterparts, with the key distinction lying in the criteria used for selecting investments. ESG funds typically employ a combination of exclusionary screens, positive selection (investing in leaders in ESG practices), and thematic investing focused on specific ESG issues. The assessment of ESG criteria involves a complex analysis of qualitative and quantitative data, ranging from carbon emissions and water usage to board composition and labor policies.

For investors, the implications are profound. The bolstering of ESG funds by regulatory tailwinds not only enhances the viability of sustainable investments but also opens new avenues for financial growth and innovation. The integration of sustainability criteria into investment decisions is becoming increasingly indispensable for achieving long-term returns and mitigating risk in a world facing unprecedented environmental challenges. This alignment of policy, investment, and technology signals a transformative shift in the financial landscape, where ESG funds are not only seen as a niche but as fundamental components of a resilient, future-proof investment strategy.

The management costs of ESG funds have become increasingly competitive with those of traditional funds. This trend is reflective of the growing efficiency and scalability within the ESG investment sector. As the market for sustainable investing matures, investors can access ESG funds and ETFs without facing significantly higher expenses, making sustainable investing more accessible and appealing to a broader audience. Here are some of the cheapest and best performing products.

Ticker	Fund name	Expense ratio (annual)
LOPP	Gabelli Love Our Planet & People ETF	0.01%
SPLG	SPDR Portfolio S&P 500 ETF	0.02%
BND	Vanguard Total Bond Market ETF	0.03%
AGG	iShares Core U.S. Aggregate Bond ETF	0.03%
VTI	Vanguard Total Stock Market ETF	0.03%
IVV	iShares Core S&P 500 ETF	0.03%
SCHB	Schwab U.S. Broad Market ETF	0.03%

In conclusion, the inflow of capital into ESG investments has seen remarkable growth, reflecting a significant shift in investor priorities towards sustainable and responsible investment. This trend is fueled by the increasing awareness of climate change, social inequalities, and corporate governance issues. Investors are keener than ever to place their capital in vehicles that not only offer financial returns but also contribute positively to environmental protection, social justice, and ethical governance. The rise in ESG investing is supported by data showing that ESG funds often match or outperform traditional investment funds, appealing to both the ethical considerations and financial interests of investors. This surge in ESG investing is reshaping the investment landscape, indicating a profound change in how capital is allocated in the global markets.

REGULATORY AND POLICY SUPPORT

As discussed above, governments and regulatory bodies have increasingly been emphasizing sustainability and ESG considerations in their policies and regulations. In this sense, a key piece of legislation, propaedeutic to meet EU' goals, is the SFDR: a cornerstone framework that requires financial operators to declare their products' positioning with respect to the overarching framework of the EU Taxonomy for sustainable activities (Schuñtze and Stede, 2021). This shift has favored ESG-oriented companies, providing them with a supportive regulatory environment and potential incentives for sustainable practices. In this context, Becker et al. (2022) provide evidence that SFDR affects EU mutual funds and individual investors. Firstly, they investigate whether funds subject to the regulation exhibit improved sustainability compared to a control group. Secondly, the study examines whether the regulation prompts individual investors to allocate a greater portion of capital to funds deemed more sustainable. Utilizing a difference-in-differences methodology, the researchers assess how the regulation influences both ESG fund scores and the net inflows. The findings indicate that funds impacted by the regulation demonstrate an increase in their sustainability rating and net inflow following the implementation of the policy intervention. This suggests a positive impact of the regulation on improving sustainability practices of the funds affected. Thus, this provides a clear market signal for asset managers to either launch new ESG funds or relabel existing funds as ESG (Articles 8 and 9) to attract investor flows.

ADAPTATION TO CHANGING CONSUMER PREFERENCES

The pandemic has accelerated certain societal trends, such as the shift towards sustainable products and services. Companies with strong ESG credentials are often better positioned to meet evolving consumer preferences, leading to increased demand for their products and services. In fact, as reported by Gruber (1996), there are two distinct groups of investors: a sophisticated clientele seeking an optimal trade-off between return and risk and another clientele motivated by social concerns, who invest regardless of performance. Especially for this type of clientele, the special focus on sustainability

developed in recent years may therefore have led them to invest in these funds (which pursue a sustainability objective). In this context, regulatory intervention plays a key role, as it has provided greater certainty by imposing more stringent sustainability criteria and disclosure requirements for this type of funds. This may have increased investors' interest and, consequently, the amount of capital invested in these funds.

FAVORABLE ACCESS TO CAPITAL

During the COVID-19 crisis, investors have increasingly acknowledged the importance of sustainability and responsible investment. Therefore, as discussed above, ESG funds have attracted significant capital inflows, providing ESG-oriented companies with access to capital at favorable terms, which can enhance their financial performance compared to non-ESG peers. Moreover, the academic literature suggests that ESG ratings can affect capital allocation and firms' cost of capital, through changing return expectations (Gibson et al., 2019) and divestment (Krueger et al., 2020). Thus, it is possible that the increase in ESG ratings, following the implementation of the legislation, may benefit the cost of capital of virtuous firms.

RESILIENCE OF SUSTAINABLE BUSINESS MODELS AND LONG-TERM VALUE CREATION

ESG-oriented companies often exhibit more resilient business models that are better equipped to face crises such as the COVID-19 pandemic. These companies tend to prioritize long-term sustainability practices, which can translate into more stable financial performance during turbulent times. This aligns with the framework proposed by Bengo et al. (2022) in their discussion of the Sustainable Finance Disclosure Regulation (SFDR) and its implications for financial institutions. The article introduces a comprehensive framework that delineates strategic methodologies and assessment tools for financial entities to promote the emergence of a more sustainable finance model. This model revolves around the fundamental concept of blended value, seeking to strike a balance between financial profitability and societal advantages, while also demonstrating a heightened focus on sustainable development.

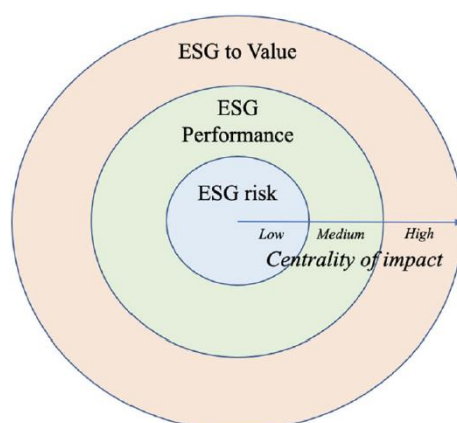


FIGURE 1 Blended value approach and the centrality of impact for sustainable finance. *Source:* own elaboration [Colour figure can be viewed at [wileyonlinelibrary.com](https://onlinelibrary.wiley.com)]

Therefore, ESG factors are often indicative of a company's ability to create long-term value for shareholders. Companies that prioritize environmental stewardship, social responsibility, and strong governance practices tend to focus on sustainable growth strategies that can deliver consistent returns over time, even in challenging market conditions. This approach, commonly referred to as impact investing, involves investments directed towards companies, organizations, and funds with the aim of generating measurable social and environmental benefits in addition to financial returns (Mudaliar et al., 2016)

RISK MANAGEMENT

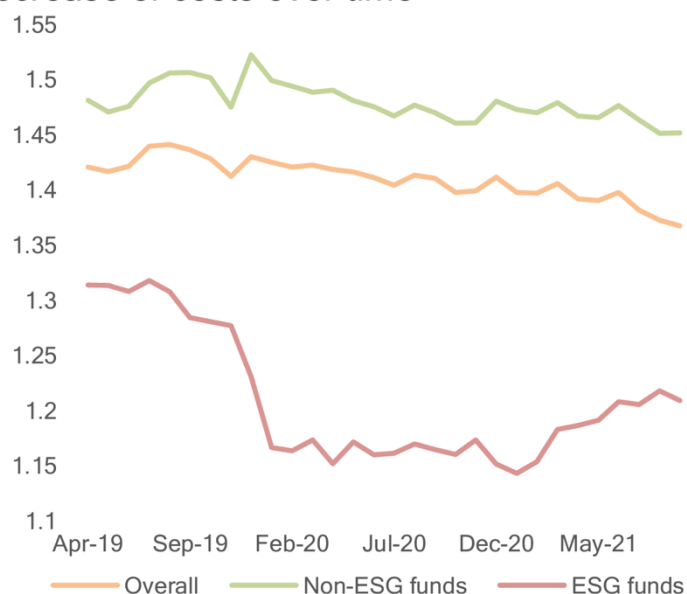
ESG funds typically integrate environmental, social, and governance factors into their investment decision-making processes. This approach often leads to better risk management practices, as companies with strong ESG profiles tend to have fewer environmental and social risks, as well as more robust governance structures. For instance, as stated by the European Banking Authority (EBA), “Financial Institutions are expected to put further effort in climate related risk management, and more broadly ESG risk management, as these risks are becoming increasingly a source of financial risk on their balance sheet...They should disclose ESG risks as well as make further efforts to adequately capture risks and vulnerabilities for ESG-related asset prices” (European Banking Authority, 2023).

This, as evidenced by Darpeix and Mosson (2021), may be reflected in potential additional costs associated with ESG funds. In fact, ESG funds may incur expenses related to the analysis of extra-financial criteria, which involves assessing environmental, social, and governance factors alongside traditional financial metrics. Compliance with regulatory requirements and industry standards for ESG investing often necessitates the procurement of certifications or labels, as well as the ongoing reporting of ESG-related performance metrics. These activities involve administrative efforts and may require investments in specialized systems or personnel, adding to the overall operational expenses of ESG funds. Furthermore, the popularity of ESG funds among investors may create incentives for fund managers to increase fees, particularly if investors prioritize the environmental or social impact of their investments over fee levels. Fund managers may capitalize on this demand by adjusting fee structures or introducing premium-priced ESG products, taking advantage of investors' willingness to pay higher fees for socially responsible investment options.

However, as reported by ESMA (2022), there are several factors that may contribute to ESG funds potentially charging lower fees and outperforming non-ESG funds. Firstly, by following an ESG strategy, investment managers may streamline their investment universe by focusing on companies that meet specific environmental, social, and governance criteria. This narrower scope can lead to reduced research costs as analysts can concentrate their efforts on a smaller set of companies with strong ESG profiles, rather than conducting extensive research across a broader universe of potential investments. Secondly, as the popularity of ESG funds grows and assets under management increase, economies of scale may come into play. Larger fund sizes can spread fixed costs over a larger asset base, resulting in lower average costs per investor. This could lead to fee reductions for investors in ESG funds, making them more cost-effective compared to non-ESG counterparts. Finally, since ESG funds are on average more recent, their pricing eventually reflects the gradual reduction of fees over time.

Average ongoing costs of equity UCITS

Decrease of costs over time



Note: Average ongoing costs of EU equity UCITS, in percent.¹¹
Sources: Morningstar, ESMA.

Having said that, it is crucial to understand how ESG funds achieve lower fees and potentially outperform non-ESG funds, as it can provide insights into making the overall fund industry more affordable and profitable for retail clients. In fact, by identifying and leveraging cost-saving mechanisms inherent in ESG investing, fund managers and regulators can work towards enhancing the accessibility and attractiveness of sustainable investment options for investors across the board.

PORTFOLIO COMPOSITION AND COST DYNAMICS

In its report, ESMA highlights the differences in portfolio composition between ESG and non-ESG funds, with ESG funds being more oriented towards large caps and developed economies.

The analysis, carried out over the period April 2019 – September 2021 showed that non-ESG funds increased their exposure to large caps and reduced their exposure to small caps (COVID-19 crisis might have led to ‘flight to quality/liquidity’ behaviours), whereas ESG funds’ exposure to large and small caps remained broadly unchanged. Nonetheless, ESG funds remained more exposed to large caps and less exposed to small caps compared to non-ESG funds. Additionally, both ESG and non-ESG funds reduced their exposure to value and growth stocks during this period, with ESG funds having greater exposure to growth stocks and non-ESG funds having greater exposure to value stocks as of September 2021.

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Table 1

The exposure of equity funds to small and large caps
Exposure of ESG funds broadly unchanged

	April 2019		September 2021	
	Non-ESG	ESG	Non-ESG	ESG
Large caps	62 % <***	67 %	65 % <**	67 %
Small caps	14 % >***	9 %	12 % >***	9 %

Note: Average of EU equity UCITS individual exposure to large and small caps as of April 2019 and September 2021. The symbols "<" and ">" indicate whether the exposure is greater for ESG or non-ESG funds. The stars represent the significance level of the differences which is reported as follows: 0.01 (***), 0.05 (**), 0.1 (*). For instance, the symbol "<****" indicates that the exposure is greater for ESG funds than for the non-ESG funds and the difference is significant at the 1 % confidence level.

Sources: Morningstar, ESMA.

Table 2

Exposure of equity funds to value and growth stocks
ESG funds less exposed to value stocks

	April 2019		September 2021	
	Non-ESG	ESG	Non-ESG	ESG
Value	29 %	29 %	27 % >***	21 %
Growth	39 % >*	38 %	30 % <***	31 %

Note: Average of EU equity UCITS individual exposure to value and growth stocks as of April 2019 and September 2021. The symbols "<" and ">" indicate whether the exposure is greater for ESG or non-ESG funds. The stars represent the significance level of the differences which is reported as follows: 0.01 (***), 0.05 (**), 0.1 (*). For instance, the symbol "<****" indicates that the exposure is greater for ESG funds than for the non-ESG funds and the difference is significant at the 1 % confidence level.

Sources: Morningstar, ESMA.

ESG funds shifted their geographical focus towards developed economies, increasing exposure to North America and Europe while decreasing exposure to other regions. Non-ESG funds, on the other hand, significantly reduced exposure to Europe and increased exposure mainly to North America and Asia. Regarding the sectoral exposure, both ESG and non-ESG funds increased exposure to communication services and healthcare stocks between April 2019 and September 2021. However, ESG funds showed a more significant rise in healthcare stocks, while non-ESG funds had a greater increase in communication services. Both types of funds partially divested consumer defensive, energy, and financial stocks during this period, with ESG funds showing a greater magnitude of divestment in all cases.

Table 3

Average geographical exposure of equity funds

Equity funds highly exposed to Europe

	April 2019		September 2021	
	ESG	Non-ESG	ESG	Non-ESG
Africa Middle East	1.5 %	1.1 %	0.6 %	1.2 %
Asia	18.5 %	22.2 %	16.8 %	22.9 %
Australia & New Zealand	1.1 %	1.4 %	1.0 %	1.2 %
Europe	46.9 %	46.0 %	48.3 %	43.3 %
North America	29.4 %	27.3 %	32.0 %	29.5 %
South America	2.7 %	1.9 %	1.3 %	2.0 %

Note: Average of EU equity UCITS individual geographical exposure as of April 2019 and September 2021. The dark green colour indicates the largest geographical exposure, the light green colour indicates the next-largest geographical exposure, while the yellow colour indicates the third-largest geographical exposure.

Sources: Morningstar, ESMA.

Table 4

Average sectoral exposure of equity funds

Equity funds highly exposed to technology

	April 2019		September 2021	
	ESG	Non-ESG	ESG	Non-ESG
Basic materials	6.4 %	7.2 %	5.9 %	7.0 %
Communication	3.3 %	2.7 %	6.9 %	7.6 %
Consumer cyclical	11.5 %	12.9 %	10.8 %	12.2 %
Consumer defensive	9.0 %	7.8 %	6.7 %	6.9 %
Energy	3.4 %	5.2 %	1.8 %	4.0 %
Financials	16.2 %	16.0 %	13.2 %	14.4 %
Healthcare	10.8 %	10.5 %	13.0 %	11.8 %
Industrials	15.3 %	12.8 %	16.6 %	12.8 %
Real Estate	4.0 %	5.5 %	3.7 %	4.0 %
Technology	16.5 %	16.8 %	18.1 %	16.6 %
Utilities	3.7 %	2.6 %	3.4 %	2.6 %

Note: Average of EU equity UCITS individual sectoral exposure as of April 2019 and September 2021 (share of each sector in percent). The dark green colour indicates the first sectoral allocation, the light green colour indicates the second sectoral allocation, while the yellow colour indicates the third sectoral allocation.

Sources: Morningstar, ESMA.

Overall, the research highlights how ESG and non-ESG funds differ in their portfolio compositions and geographic exposures, with ESG funds showing relatively stable exposures to large and small caps and a greater focus on growth stocks, developed economies, and certain sectors such as healthcare. This orientation is correlated with lower ongoing costs, suggesting that the composition of ESG portfolios may contribute to their cost-effectiveness.

LOW-COST ESGs

To establish whether ESG funds remained cheaper with respect to non-ESG peers, even after controlling for differences in portfolio composition and tracking error, ESMA also provides the results for the following model estimated through pooled Ordinary Least Square (pooled OLS), with standard errors clustered at the individual level.

$$\begin{aligned}
 Y_{i,t} &= \alpha_0 + \alpha_1 ESG_{i,t} + \alpha_2 date_t + \alpha_3 clients_i \\
 &+ \alpha_4 management_i + \alpha_5 feederFOF_i \\
 &+ \alpha_6 developed economies_{i,t} + \alpha_7 domicile_i \\
 &+ \alpha_8 large caps_{i,t} + \alpha_9 value stock_{i,t} \\
 &+ \alpha_{10} utility sector_{i,t} + \alpha_{11} basic materials sector_{i,t} \\
 &+ \alpha_{12} communication sector_{i,t} \\
 &+ \alpha_{13} consumer cyclical sector_{i,t} \\
 &+ \alpha_{14} consumer defensive sector_{i,t} \\
 &+ \alpha_{15} energy sector_{i,t} + \alpha_{16} financial sector_{i,t} \\
 &+ \alpha_{17} healthcare sector_{i,t} \\
 &+ \alpha_{18} industrial sector_{i,t} + \alpha_{19} technology sector_{i,t} \\
 &+ \alpha_{20} age_{i,t} + \alpha_{21} \log(net assets)_{i,t} \\
 &+ \alpha_{22} Asset Management Company_i + \varepsilon_{i,t}
 \end{aligned}$$

They found that despite controlling for fund characteristics and portfolio exposures, ESG funds remained statistically cheaper and better performing than non-ESG peers. In particular, ESG funds are associated with lower ongoing costs by 0.080 percentage points (standard model) compared to non-ESG funds. Furthermore, funds created as ESG are found to be the cheapest, followed by funds that converted to ESG. Older ESG funds show the smallest difference in costs compared to non-ESG funds. Then, there's also a significant difference in costs between the periods when funds were identified as non-ESG and when they were identified as ESG, particularly for converted funds.

Regarding the impact of ESG strategies on funds ongoing costs, ESMA found that impact funds (funds that follows impact investing strategies) and funds following other ESG strategies are cheaper than non-ESG funds, with impact funds being the cheapest category. This suggests that certain ESG strategies may lead to lower costs compared to non-ESG strategies.

Finally, other factors impacting costs include whether the fund targets institutional clients, management style (passive vs. active), and fund structure (fund of funds or feeder funds), but these results were already known in the literature.

ESG OUTPERFORMANCE

The goal is to explain the determinants of the overperformance of ESG funds. Indeed, as highlighted in the previous sections, it is important to keep in mind that ESG funds increased some of their exposure to sectors that performed well at the peak of the COVID-19 crisis (e.g., the healthcare sector). To conduct such an analysis, ESMA focuses on the monthly gross performance and examines several factors contributing to the outperformance of ESG (Environmental, Social, and Governance) funds compared to non-ESG funds.

The results show that while ESG funds did increase exposure to certain sectors during the COVID-19 crisis, including sectoral exposures in the analysis did not change the finding that ESG funds outperformed non-ESG funds. This suggests that sectoral exposure alone cannot entirely explain the

outperformance of ESG funds. Moreover, ESG funds still outperform non-ESG funds even after controlling for tracking error and other fund characteristics like size, age, and management style.

Finally, the analysis also explores the impact of carbon exposure on fund performance and finds that higher exposure to environmental risks, as measured by carbon risk scores, is associated with greater performance. This result could indicate that the outperformance of ESG funds might not hold for funds focusing on the E pillar. So, to test this hypothesis, the study carried out another regression which distinguishes between different ESG strategies, including impact funds and funds focusing on environmental (E), social (S), or governance (G) aspects. The outcome shows that funds focusing on the S or G pillars significantly outperform non-ESG funds, while the performance of funds focusing on the E pillar is not statistically different from non-ESG funds.

CONCLUSIONS

Considering what has been discussed so far, the reasons for the outperformance of ESG funds compared to non-ESG funds during the Covid period are multiple. Firstly, it is necessary to recall the introduction of various regulations, foremost among them the SFDR, aimed at regulating the dissemination of these products in the market in a transparent and sustainable manner. Secondly, reference must also be made to the increasing interest in these themes within governments and institutions, as well as in public opinion, which resulted in these funds receiving significant attention during the reference period. Finally, the different composition of the portfolio, with a predominant exposure to certain sectors and geographic areas, as well as the different cost structure and management practices and strategies, meant that during the pandemic period, ESG funds outperformed non-ESG funds.

In particular, the analysis initially revealed that ESG funds generally have higher exposure to large caps and tend to focus more on developed economies, which correlates with lower ongoing costs. Even after considering factors such as institutional client targeting, passive management, and fund age, ESG funds remained less expensive than non-ESG funds by an average of 0.080 percentage points from April 2019 to September 2021. Additionally, among ESG funds, those established as ESG funds from the start tended to have lower fees compared to those that were originally conventional funds and later converted to ESG funds. Impact funds also exhibited lower costs compared to ESG funds employing other strategies. Furthermore, differences in sectoral allocation were observed between ESG and non-ESG funds, with ESG funds showing higher exposure to healthcare and technology sectors. However, these differences alone did not account for the outperformance of ESG funds. Interestingly, funds with higher environmental risk were associated with higher performance, which could be explained by the overperformance of funds focusing on the S pillar or on the G pillar compared to those focusing solely on the E pillar during the specified period.

In conclusion, given the growing interest in ESG investing and the importance of investor protection, ongoing monitoring of costs in the ESG market is crucial. Future research could explore the reasons behind the relative affordability of ESG funds, potentially considering total costs instead of just ongoing charges. Additionally, analyzing both financial and environmental/social performance together would be valuable, along with assessing risk-adjusted performance to determine if the outperformance of ESG funds persists when accounting for risk. However, conducting in-depth analyses of costs may be challenging due to limited data availability in this area.

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